6

Tax-Free Exchanges of Property

You may exchange property without incurring a tax in the year of exchange if you meet the rules of this chapter. Gain may be taxed upon a later disposition of the property because the basis of the property received in the exchange is usually the same as the basis of the property surrendered in the exchange. Thus, if you exchange property with a tax basis of $10,000 for property worth $50,000, the basis of the property received in exchange is fixed at $10,000, even though its fair market value is $50,000. The gain of $40,000 ($50,000 – $10,000), which is not taxed, is technically called "unrecognized gain." If you later sell the property for $50,000, you will realize a taxable gain of $40,000 ($50,000 – $10,000).

Where property received in a tax-free exchange is held until death, the unrecognized gain escapes tax forever because basis of the property in the hands of an heir is generally the value of the property at the date of death. If the exchange involves the transfer of boot, such as cash or other property, gain on the exchange is taxable to the extent of the value of boot.

You may not exchange tax-free U.S. real estate for foreign real estate.

Tax-free exchanges between related parties may become taxable if either party disposes of the exchanged property within a two-year period.

	See ¶
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¶6.1 Trades of Like-Kind Property

You may not have to pay tax on gain realized on the "like-kind" exchange of business or investment property. By making a qualifying exchange, you can defer the gain. For tax-free treatment, you must trade property held for business use or investment for like-kind business or investment property. If the properties are not simultaneously exchanged, the time limits of ¶6.4 must be satisfied. Gain is *completely* tax free only if you do not receive any "boot"; as discussed in ¶6.3, gain is taxed to the extent of boot received. Where gain on a qualifying exchange is deferred and not immediately taxed, it may be taxable in a later year when you sell the property because your basis for the new property is generally the same as the basis for the property you traded; basis is discussed at ¶5.20.

If you make a qualifying like-kind exchange with certain related parties, tax-free treatment may be lost unless both of you keep the exchanged properties for at least two years; *see* ¶6.5.

The term *like kind* refers to the nature or character of the property, that is, whether real estate is traded for real estate. It does not refer to grade or quality, that is, whether the properties traded are new or used. In the case of real estate, land may be traded for a building, farm land for city lots, or a leasehold interest of 30 years or more for an outright ownership in realty. Trades of personal property are discussed at ¶6.2.

EXAMPLES

1. Jones, a real estate investor, purchased a parcel for investment in 1984 for $5,000. In 1995, he exchanged it for another parcel, Parcel B, which had a fair market value of $50,000. The gain of $45,000 was not taxed in 1995.
2. Same facts as above, except that in 1996 Jones sells Parcel B for $50,000. His taxable gain is $45,000. The "tax-free" rules have the effect of deferring tax on appreciation. Tax is finally imposed when the exchanged item is sold.
3. Same facts as in 1 above, but the value of Parcel B was $3,000. Jones could not deduct the loss in 1995. The basis of the parcel is $5,000. If Jones sells Parcel B in 1996 for $3,000, he may deduct a loss of $2,000.

Losses. If a loss is incurred on a like-kind exchange, the loss is not deductible, whether you receive only like-kind property or "unlike" property together with like-kind property. However, a deductible loss may be incurred if you give up unlike property as part of the exchange; the loss equals any excess of the adjusted basis of the unlike property over its fair market value.

Reporting an exchange. You must file Form 8824 to report an exchange of like-kind property. If you figure a recognized gain or loss on Form 8824, you also must report the exchange on Schedule D (investment property) or Form 4797 (business property).

See ¶6.5 for reporting an exchange with a related party.

Property not within the tax-free trade rules:

Property used for personal purposes (except for exchanges of personal residences; *see* Chapter 29).

Foreign real estate.

Property held for sale.

Inventory or stock-in-trade.

Securities; *see* ¶6.2 for exception.

Notes.

Partnership interest; *see* below.

See also ¶31.4 for tax-free exchanges of realty and ¶11.8 for tax-free exchanges of insurance policies.

Exchange of partnership interests. Exchanges of partnership interests in different partnerships are not within the tax-free exchange rules. Under IRS regulations, tax-free exchange treatment is denied regardless of whether the interests are in the same or different partnerships.

If you made an election to exclude a partnership interest from the application of partnership rules, your interest is treated as interest in each partnership asset, not as an interest in the partnership.

Real estate in foreign countries. You may not make a tax-free exchange of U.S. real estate for foreign real estate. However, in the case of an involuntary conversion (¶18.22), a tax-free reinvestment may be made in foreign real estate.

¶6.2 Personal Property Held for Business or Investment

An exchange of depreciable tangible personal property held for productive business or investment use may qualify for tax-free treatment if it meets either the general like-kind test of ¶6.1 or a more specific "like-class" test created by IRS regulations. The assumption of liabilities is treated as "boot"; *see* ¶6.3. Where each party assumes a liability of the other party, the respective liabilities are offset against each other to figure boot, if any.

Under the like-class test, there are two types of "like" classes: (1) General Asset Classes; and (2) Product Classes. The like-class test is satisfied if the exchanged properties are both within the same General Asset Class or the same Product Class. A specific asset may be classified within only one class. Thus, if an asset is within an Asset Class, it may not be within a Product Class. The Asset Class or Product Class is determined as of the date of the exchange. This limitation may disqualify an exchange when exchanged assets do not fit within the same Asset Class and are not allowed to qualify within the Product Class; *see* the Brown Example on the next page.

General Asset Classes. There are 13 classes of depreciable tangible business property. Here are some of the asset classifications: office furniture, fixtures, and equipment (class 00.11); information systems: computers and peripheral equipment (class 00.12); data handling equipment, except computers (class 00.13); airplanes and helicopters, except for airplanes used to carry passengers or freight (class 00.21); automobiles and taxis (class 00.22); light trucks (class 00.241); heavy trucks (class 00.242); and over-the-road tractor units (class 00.26). For example, trades of trucks in class 00.241 would be of like class.

Product Classes. Under a coding system of the Standard Industrial Classification Manual (SIC), tangible depreciable assets are assigned a four-digit product-class number. For example, a grader is exchanged for a scraper. Neither item is within a General Asset Class, but both are in the same Product Class as SIC Code 3533. They are, therefore, of a like class.

EXAMPLES

1. Baker exchanges a personal computer used in his business for a printer. Both assets are productively used in business and are in the same General Asset Class of 00.12; the exchange meets the like-class test.
2. Brown exchanges an airplane (asset class 00.21) used in her business for a heavy truck (asset class 00.242). The exchanged properties are not of a like class. Furthermore, since each property is within a specific General Asset Class, the Product Class test may not be applied to qualify the exchange. Brown must report any gain realized on the exchange because the properties also do not meet the general like-kind test.

Intangible personal property and goodwill. Exchanges of intangible personal property (such as a patent or copyright) or nondepreciable personal property must meet the general like-kind test to qualify for tax-free treatment; the like-class tests do not apply. However, regulations close the door for qualifying exchanges of goodwill in an exchange of going businesses. According to the regulations, goodwill or going concern value of one business can never be of a like kind to goodwill or going concern value of another business.

Exchanges of multiple properties. Generally, exchanges of assets are considered on a one-to-one basis. Regulations provide an exception for exchanges of multiple properties, such as on an exchange of businesses. Transferred assets are separated into exchange groups. An exchange group consists of all properties transferred and received in the exchange which are of a like kind or like class. All properties within the same General Asset Class or same Product Class are in the same exchange group. For example, automobiles and computers are exchanged for other automobiles and computers; two exchange groups are set up—one for the automobiles and the other for the computers. If the aggregate fair market values of the properties transferred and received in each exchange group are not equal, the regulations provide calculations for setting up a residual group for purposes of calculating taxable gain, if any.

All liabilities of which a taxpayer is relieved in the exchange are offset against all liabilities assumed by the taxpayer in the exchange, regardless of whether the liabilities are recourse, nonrecourse, or are secured by the specific property transferred or received. If excess liabilities are assumed by the taxpayer as part of the exchange, regulations provide rules for allocating the excess among the properties.

¶6.3 Receipt of Cash and Other Property—"Boot"

If, in addition to like-kind (¶6.1) property, you receive cash or other property (unlike kind), gain is taxable up to the amount of the cash or other property received. The additional cash or other property is called "boot." If a loss was incurred on the exchange, the receipt of boot does not permit you to deduct the loss unless it is attributable to *unlike*-kind property you gave up in the exchange.

If you transfer mortgaged property, the amount of the mortgage is part of your boot. If both you and the other party transfer and receive mortgaged property, the party giving up the larger debt treats the excess as taxable boot. The party giving up the smaller debt does not have boot; *see also* ¶31.4. If you pay cash to the other party, add this to the mortgage you receive in figuring which party has given up the larger debt.

Form 8824. The computation of boot, gain (or loss), and basis of the property received is made on Form 8824.

EXAMPLE

Jones owns an apartment house with a fair market value of $220,000, subject to an $80,000 mortgage. His adjusted basis is $100,000. Jones exchanges his building for Smith's apartment building, which has a value of $250,000, subject to a $150,000 mortgage. Jones also receives $40,000 in cash. Smith's adjusted basis for the building he trades is $175,000. Smith and Jones each pay $5,000 in exchange expenses.

The sample Forms 8824 for Jones and Smith on the next page show how they report the exchange. On Line 15, they show the boot received; their taxable gain is limited to this boot. For Jones, boot is the cash boot of $40,000. For Smith, the Line 15 boot is $30,000:

Mortgage transferred to Jones		$150,000
Less: Mortgage assumed by Smith	$80,000	
Plus: Cash paid by Smith	40,000	120,000
		$ 30,000

On Line 18, Jones and Smith increase their basis for the buildings they traded by exchange expenses and the net amounts paid to the other party. For Jones, the Line 18 total of $175,000 includes:

Adjusted basis of building traded		$100,000
Exchange expenses		5,000
Net mortgage assumed:		
Mortgage assumed	$150,000	
Less: Mortgage transferred	80,000	70,000
		$175,000

For Smith the Line 18 total of $180,000 includes:

Adjusted basis of building traded		$175,000
Exchange expenses		5,000
Net amount paid:		
Mortgage assumed	$80,000	
Cash paid	40,000	
	120,000	
Less: Mortgage transferred	150,000	0
		$180,000

Line 25 shows the basis of the buildings Jones and Smith receive in the exchange.

Sample Form 8824 for Jones (*see* Example on previous page)

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: *If you transferred and received (a) more than one group of like-kind properties, or (b) cash or other (not like-kind) property, see instructions under* ***Multi-Asset Exchanges.***

Note: *Complete lines 12 through 14 ONLY if you gave up property that was not like-kind. Otherwise, go to line 15.*

12	Fair market value (FMV) of other property given up	12	
13	Adjusted basis of other property given up	13	
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale	14	
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions	15	40,000
16	FMV of like-kind property you received	16	250,000
17	Add lines 15 and 16	17	290,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15. See instructions	18	175,000
19	**Realized gain or (loss).** Subtract line 18 from line 17	19	115,000
20	Enter the smaller of line 15 or line 19, but not less than zero	20	40,000
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 17. See instructions	21	-0-
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions	22	40,000
23	**Recognized gain.** Add lines 21 and 22	23	40,000
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24	75,000
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23	25	175,000

Sample Form 8824 for Smith (*see* Example on previous page)

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: *If you transferred and received (a) more than one group of like-kind properties, or (b) cash or other (not like-kind) property, see instructions under* ***Multi-Asset Exchanges.***

Note: *Complete lines 12 through 14 ONLY if you gave up property that was not like-kind. Otherwise, go to line 15.*

12	Fair market value (FMV) of other property given up	12	
13	Adjusted basis of other property given up	13	
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale	14	
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions	15	30,000
16	FMV of like-kind property you received	16	220,000
17	Add lines 15 and 16	17	250,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15. See instructions	18	180,000
19	**Realized gain or (loss).** Subtract line 18 from line 17	19	70,000
20	Enter the smaller of line 15 or line 19, but not less than zero	20	30,000
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 17. See instructions	21	-0-
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions	22	30,000
23	**Recognized gain.** Add lines 21 and 22	23	30,000
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24	40,000
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23	25	180,000

¶6.4 Time Limits for Deferred Exchanges

Assume you own property which has appreciated in value. You want to sell it and reinvest the proceeds in other property, but you would like to avoid having to pay tax on the appreciation. You can avoid the tax if you are able to arrange an exchange for similar property.

The problem is that it may be difficult to find a buyer who has property you want in exchange, and the time for closing the exchange is restricted. If IRS tests are met, intermediaries and security arrangements may be used without running afoul of constructive receipt rules that could trigger an immediate tax.

Time limits for completing exchanges. You generally have up to 180 days to complete an exchange, but the deadline may end sooner. Specifically, property will not be treated as like-kind property if received (1) more than 180 days after the date you transferred the property you are relinquishing; or (2) the due date of your return (including extensions) for the year in which you made the transfer, whichever is earlier. Furthermore, the property to be received must be identified within 45 days after the date on which you transferred property.

If the transaction involves more than one property, the 45-day identification period and the 180-day exchange period are determined by the earliest date on which any property is transferred. When the identification or exchange period ends on a Saturday, Sunday, or legal holiday, the deadline is not advanced to the next business day (as it is when the deadline for filing a tax return is on a weekend or holiday).

Strict Time Limits

No extensions of time are allowed if the 45-day or 180-day statutory deadlines cannot be met. If extra time is needed for finding suitable replacement property, it is advisable to delay the date of your property transfer because the transfer date starts the 45-day identification period.

How to identify property. You must identify replacement property in a written document signed by you and either hand delivered, mailed, telecopied, or otherwise sent before the end of the 45-day identification period to a person involved in the exchange other than yourself or a related party. The identification may also be made in a written agreement. The property must be unambiguously described by a legal description or street address.

You may identify more than one property as replacement property. However, the maximum number of replacement properties that you may identify without regard to the fair market value is three properties. You may identify any number of properties provided the aggregate fair market value at the end of the 45-day identification period does not exceed 200% of the aggregate fair market value of all the relinquished properties as of the date you transferred them. If, as of the end of the identification period, you have identified more than the allowable number of properties, you are generally treated as if no replacement property has been identified.

Receipt of security. In a deferred exchange, you want financial security for the buyer's performance and compensation for delay in receiving property. To avoid immediate tax, you must not make a security arrangement that gives you an unrestricted right to funds before the deal is closed.

EXAMPLE

You and Jones agree to enter a deferred exchange under the following terms and conditions. On May 17, 1996, you transfer to Jones real estate which has been held for investment; it is unencumbered and has a fair market value of $100,000. On or before July 1, 1996 (the end of the 45-day identification period), you must identify like-kind replacement property. On or before November 13, 1996 (the end of the 180-day exchange period), Jones is required to buy the property and transfer it to you. At any time after May 17, 1996, and before Jones has purchased the replacement property, you have the right, upon notice, to demand that he pay you $100,000 instead of acquiring and transferring the replacement property. However, you identify replacement property, and Jones purchases and transfers it to you. According to the regulations, you have an unrestricted right to demand the payment of $100,000 as of May 17, 1996. You are therefore in constructive receipt of $100,000 on that date. Thus, the transaction is treated as a taxable sale, and the transfer of the real property does not qualify as a tax-free exchange. You are treated as if you received the $100,000 for the sale of your property and then purchased replacement property.

Safe harbor tests for security arrangements. If one of the following safe harbors applies to your security arrangement, you are not taxed as if a sale were made.

The first two "safe harbors" cover transfers dealing directly with the buyer. The third allows the use of professional intermediaries who, for a fee, arrange the details of the exchange. The fourth allows you to earn interest on an escrow account. The safe harbors generally prohibit you from receiving money or other non–like-kind property before replacement property is received. The terms of the agreement govern whether your right to receive the funds is limited as required by the safe harbor rules; possible state law complications are disregarded.

1. The transferee may give you a mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent), or a third-party guarantee. A standby letter of credit may be given if you are not allowed to draw on such standby letter except upon a default of the transferee's obligation to transfer like-kind replacement property.
2. The transferee may put cash or a cash equivalent in a qualified escrow account or a qualified trust. The escrow holder or trustee must not be related to you. Your rights to receive, pledge, borrow, or otherwise obtain the cash must be limited. For example, you may obtain the cash after all of the replacement property to

which you are entitled is received. After you identify replacement property, you may obtain the cash after the later of (1) the end of the identification period; and (2) the occurrence of a contingency beyond your control that you have specified in writing. You may receive the funds after the end of the identification period if within that period you do not identify replacement property. In other cases, there can be no right to the funds until the exchange period ends.

3. You may use a *qualified intermediary* if your right to receive money or other property is limited (as discussed in safe harbor rule 2, above). A qualified intermediary is an unrelated party who, for a fee, acts to facilitate a deferred exchange by entering into an agreement with you for the exchange of properties pursuant to which the intermediary acquires your property from you, acquires the replacement property, and transfers the replacement property to you. The acquisitions may be on the intermediary's own behalf or as the agent of any party to the transaction.

   The transfer of property that is facilitated by the use of a qualified intermediary may occur through a "direct deed" of legal title by the current owner of the property to you. The transferee of your property does *not* have to receive title to the property you want and then transfer it to you.

   There are restrictions on who may act as an intermediary. You may not employ any person as an intermediary who is your employee or is related to you or has generally acted as your professional adviser such as an attorney, accountant, investment broker, real estate agent, or banker in a two-year period preceding the exchange. Related parties include family members and controlled businesses or trusts (*see* ¶33.10), except that for purposes of control, a 10% interest is sufficient under the intermediary rule. The performance of routine financial, escrow, trust, or title insurance services by a financial institution or title company within the two-year period is not taken into account. State laws which may be interpreted as fixing an agency relationship between the transferor and transferee or fixing the transferor's right to security funds are ignored.

   In a simultaneous exchange, the intermediary is not considered the transferor's agent.

4. You are permitted to receive interest or a "growth factor" on escrowed funds if your right to receive the amount is limited as discussed under safe harbor rule 2.

Payment of acquisition and closing costs. The use of funds from a security account to pay specific acquisition and closing costs such as commissions, prorated taxes, and recording and transfer fees will not result in constructive receipt of the remaining funds.

¶6.5 Exchanges Between Related Parties

Tax-free treatment of like-kind exchanges between related persons may be lost, if either party disposes of property received in the exchange within two years after the date of the last transfer that was part of the exchange. Any gain not recognized on the original exchange is taxable as of the date of the later disposition of the original like-kind property by either party within the two-year period. If a loss was not recognized, the loss becomes deductible if allowed under the rules of ¶33.10. This two-year rule does not apply to transfers made under a written binding contract that was in effect on and after July 10, 1989, or to the exceptions listed below.

Indirect dispositions of the property within the two-year period, such as transfer of stock of a corporation or interests in a partnership that owns the property, may also be treated as taxable dispositions.

Related parties. Related persons falling within the two-year rule include your children, grandchildren, parent, brother, or sister, controlled corporations or partnerships (more than 50% ownership), and a trust in which you are a beneficiary. A transfer to a spouse is not subject to the two-year rule unless he or she is a nonresident alien.

Plan to avoid two-year rule. If you set up a prearranged plan under which you first transfer property to an unrelated party who within two years makes an exchange with a party related to you, the related party will not qualify for tax-free treatment on that exchange.

Exceptions. No tax will be incurred on a disposition made because of death; in an involuntary conversion provided the original exchange occurred before the threat of the conversion; or if you can prove that neither the exchange nor the later disposition was for a tax avoidance purpose.

Filing Form 8824

The IRS requires related parties who exchange property to file Form 8824 for the year of the exchange and also for the two years following the exchange. If either party disposes of the property received in the original exchange in any of these years, the deferred gain must be reported in the year of disposition as if the property had been sold.

¶6.6 Property Transfers Between Spouses and Ex-Spouses

All transfers between spouses are tax-free, *other than* transfers to a nonresident alien spouse, certain trust transfers of mortgaged property, and transfers of U.S. Savings Bonds; these exceptions are discussed below. The tax-free exchange rules apply to transfers during marriage as well as to property settlements incident to a divorce. A transfer is "incident to a divorce" if it occurs either within one year after the date the marriage ceases or, if later, is related to the cessation of the marriage, such as a transfer authorized by a divorce

decree. Under temporary regulations, any transfer pursuant to a divorce or separation agreement occurring within six years of the end of the marriage is considered "incident to a divorce." Later transfers qualify only if a transfer within the six-year period was hampered by legal or business disputes such as a fight over the property value.

Recipient Spouse Bears Tax Consequences

Under the tax-free exchange rules, there is no taxable gain or deductible loss on the transfer of property, even if cash is received for the property or the other spouse (or former spouse) assumes liabilities or gives up marital rights as part of a property settlement. The spouse who receives property may incur tax on a later sale because his or her basis in the property is the same as the transferor-spouse's basis; *see* the Examples below. Because the transferee bears the tax consequences of a later sale, he or she should consider the potential tax on the appreciation in negotiating a marital settlement. In a marital settlement, the transferee spouse can lessen the tax burden by negotiating for assets that have little or no unrealized appreciation.

Nonresident alien. The tax-free exchange rule does not apply to transfers to a nonresident alien spouse or former spouse. A transfer before June 22, 1988, to a former spouse who was a nonresident alien was subject to the tax-free exchange rule if the transfer was "incident to a divorce."

EXAMPLES

1. In a property settlement accompanying a divorce, a husband plans to transfer to his wife stock worth $250,000 that cost him $50,000. In deciding whether to agree to the transfer, the wife should be aware that her basis for the stock will be $50,000; if she sells the stock, she will have to pay tax on the $200,000 gain. This tax cost should be accounted for in arriving at the settlement.
2. Basis of the property in the hands of the transferee-spouse is not increased even if cash is paid as part of the transfer. For example, a husband received a house originally owned by the wife as part of a marital settlement. Her basis for the house was $32,200. He paid her $18,000 cash as part of the settlement and when he later sold the house for $64,000, he argued that his basis for purposes of computing profit was $50,200—the wife's $32,200 basis plus his $18,000 cash payment. The IRS refused to consider the cash payment as part of basis, and the Tax Court agreed that the carryover basis rule applies.

Transfers to Third Parties

A transfer to a third party on behalf of a spouse or former spouse qualifies for tax-free exchange treatment where the transfer is required by a divorce or separation instrument, or if you have your spouse's or former spouse's written request or consent for the transfer. The transfer is treated as if made to your spouse or former spouse, who then retransfers the property to the third party. A written request or consent must specifically state that the tax-free exchange rules of Code Section 1041 are intended, and you must receive it before filing the tax return for the year of the transfer; but *see* divorce-related stock redemption below.

Is a divorce-related redemption of stock in a closely held corporation subject to the tax-free exchange rules? The IRS has consistently disputed tax-free treatment for a spouse whose closely held corporation's stock is redeemed as part of an overall divorce settlement. It argues that a stock redemption between one spouse and a closely held corporation results in a taxable sale and does not fall within the exception for transfers to third parties, discussed above in the Filing Pointer. To hedge against the possibility that a court may rule against its position that the redeeming spouse should be taxed on the proceeds, the IRS will maintain a fallback position: If the redeeming spouse is not taxable, the nonredeeming shareholder should be treated as having received a taxable constructive dividend as a result of the redemption.

EXAMPLES

1. The IRS position that a closely held corporation's redemption of one spouse's stock is taxable was rejected by a federal district court and the Ninth Circuit Court of Appeals, which held that a wife was not taxable on the redemption of her stock by the couple's closely held corporation where the redemption was pursuant to their divorce agreement and incorporated into the divorce decree. The Ninth Circuit viewed the transfer as if the husband had received the stock directly from the wife and then transferred it to the company.

   After the Ninth Circuit held that the redemption was not taxable to the wife, the IRS argued in a separate case against the nonredeeming husband that he received a taxable constructive dividend. However, the Tax Court disagreed, holding that there was no dividend to the husband because under state law he was merely a guarantor; he was not primarily and unconditionally obligated to buy the stock. The IRS did not appeal the Tax Court decision.

   In this unusual case, the IRS is in the position of being unable to collect tax on the redemption proceeds from either the transferor or transferee spouse.

2. The Tax Court refused to follow the Ninth Circuit decision referred to in Example 1 and denied tax-free treatment to a redeeming spouse although the redemption was required by the divorce decree. The Tax Court held that the redemption did not satisfy an obligation of the nonredeeming spouse, and thus it was not paid on his behalf.

Transfers of U.S. Savings Bonds. The IRS has ruled that the tax-free exchange rules do not apply to transfers of U.S. Savings Bonds. For example, if a husband has deferred the reporting of interest on E or EE bonds and transfers the bonds to his ex-wife as part of a divorce settlement, the deferred interest is taxed to him on the transfer. The wife's basis for the bonds is the husband's basis plus the income he realizes on the transfer. When she redeems the bonds, she will be taxed on the interest accrued from the date of the transfer to the redemption date.

Payment for release of community property interest in retirement pay. The Tax Court allowed tax-free treatment for a payment made to a wife for releasing her community property claim to her husband's military retirement pay. The IRS had argued that the tax-free exchange rules discussed in this section did not apply to the release of rights to retirement pay that would otherwise be subject to ordinary income tax. The Tax Court disagreed, holding that the tax-free exchange rule applies whether the transfer is for relinquishment of marital rights, cash, or other property.

Transfers in trust. The tax-free exchange rules generally apply to transfers in trust for the benefit of a spouse or a former spouse if incident to a divorce. However, if the trust property is mortgaged, the transferor spouse must report a taxable gain to the extent that the liabilities assumed by the transferee spouse plus the liabilities to which the property is subject (even if not assumed) exceed the transferor's adjusted basis for the property. If the transferor realizes a taxable gain under this rule, the transferee's basis for the property is increased by the gain.

CAUTION

Trust Transfer of Leveraged Property

You will not be able to avoid gain on heavily mortgaged property transferred to a trust for your spouse or to a former spouse under a divorce decree. The excess of the liabilities on the property over your adjusted basis is taxable gain.

Sole proprietorship sale to spouse. Tax-free exchange rules may apply to a sale of business property by a sole proprietor to a spouse. The buyer spouse assumes a carryover basis even if fair market value is paid. The transferor is not required to recapture previously claimed depreciation deductions or investment credits. However, the transferee is subject to the recapture rules on premature dispositions or if the property ceases to be used for business purposes.

Agreements existing on July 18, 1984. The tax-free exchange rules generally apply to transfers made after July 18, 1984. Transfers made under agreements in effect before July 19, 1984, are subject to the tax-free rule only if both spouses make an election to have the tax-free rule apply. The election must be made on a signed statement attached to the first tax return filed by the transferor-spouse for the year in which the first transfer occurs. The transferor must also attach the statement to returns for later years in which a transfer is made under the election.

¶6.7 Tax-Free Exchanges of Stock

Gain on the exchange of common stock for other common stock (or preferred for other preferred of the same company) is not taxable. Similarly, loss realized on such an exchange is not deductible. The exchange may take place between the stockholder and the company or between two stockholders.

An exchange of preferred stock for common, or common for preferred, in the same company, is generally not tax free, unless the exchange is part of a tax-free recapitalization. In such exchanges, the company should inform you of the tax consequences.

Convertible securities. Conversion of securities under a conversion privilege is tax free under the rules discussed at ¶30.8.

¶6.8 Joint Ownership Interests

The change to a tenancy in common from a joint tenancy is tax free. You may convert a joint tenancy in corporate stock to a tenancy in common without income-tax consequences. The transfer is tax free even though survivorship rights are eliminated. Similarly, a partition and issuance of separate certificates in the names of each joint tenant is also tax free.

A joint tenancy and a tenancy in common differ in this respect. On the death of a joint tenant, ownership passes to the surviving joint tenant or tenants. But on the death of a tenant holding property in common, ownership passes to his or her heirs, not to the other tenant or tenants with whom the property was held.

A tenancy by the entirety is a form of joint ownership recognized in some states and can be only between a husband and wife.

Dividing properties held in common. A division of properties held as tenants in common may qualify as tax-free exchanges.

For example, three men owned three pieces of real estate as tenants in common. Each man wanted to be the sole owner of one of the pieces of property. They disentangled themselves by exchanging interests in a three-way exchange. No money or property other than the three pieces of real estate changed hands, and none of the men assumed any liability of the others. The transactions qualified as tax-free exchanges and no gain or loss was recognized.

Receipt of boot. Exchanges of jointly owned property are tax free as long as no "boot," such as cash or other property, passes between the parties; *see* ¶6.3.

¶6.9 Setting Up Closely Held Corporations

Tax-free exchange rules facilitate the organization of a corporation. When you transfer property to a corporation that you control solely in exchange for corporate stock, no gain or loss is recognized on the transfer. For control, you alone or together with other transferrers (such as partners, where a partnership is being incorporated) must own at least 80% of the combined voting power of the corporation and 80% of all other classes of stock immediately after the transfer to the corporation. If you receive securities in addition to stock, the securities are treated as taxable "boot."

The corporation takes your basis in the property, and your basis in the stock received in the exchange is the same as your basis in the property. Thus, gain not recognized on the organization of the corporation may be taxed when you sell your stock, or the corporation disposes of the property.

EXAMPLE

You transfer a building worth $100,000, which cost you $20,000, to your newly organized corporation in exchange for all of its outstanding stock. You realize an $80,000 gain ($100,000 – $20,000) which is not recognized. Your basis in the stock is $20,000; the corporation's basis in the building is $20,000. The following year, you sell all your stock to a third party for $100,000. The $80,000 gain is now recognized.

Transfer of liabilities. When assets subject to liabilities are transferred to the corporation, the liability assumed by the corporation is not treated as a taxable "boot," but your stock basis is reduced by the amount of liability. The transfer of liabilities may be taxable when the transfer is part of a tax avoidance scheme, or the liabilities exceed the basis of the property transferred to the corporation.

CAUTION

Consider Taxable Transfer

Before making a property transfer to a closely held corporation, consult an accountant or an attorney on the tax consequences. It may not be to your advantage to fall within the tax-free exchange rules. This is so when you have property with potential losses or you wish the corporation to take a stepped-up basis for property.

¶6.10 Exchanges of Coins and Bullion

An exchange of "gold for gold" coins or "silver for silver" coins may qualify as a tax-free exchange of like-kind investment property. An exchange is tax free if both coins represent the same type of underlying investment. An exchange of bullion-type coins for bullion-type coins is a tax-free like-kind exchange. For example, the exchange of Mexican pesos for Austrian coronas has been held to be a tax-free exchange as both are bullion-type coins.

However, an exchange of silver bullion for gold bullion is not tax free. Silver and gold bullion represent different types of property. Silver is an industrial commodity, whereas gold is primarily an investment in itself. Similarly, an exchange of U.S. gold collector's coins for South African Krugerrands is taxable. Krugerrands are bullion-type coins whose value is determined solely by metal content, whereas the U.S. gold coins are numismatic coins whose value depends on age, condition, number minted, and artistic merit, as well as metal content. Although both coins appear to be similar in gold content, each represents a different type of investment.